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FOR E - UNDER SECRETARY WALLIS FROM HOLMES

E.O. 12356: DECL: OADR
TAGS: EFIN, IT
SUBJECT: OFFICIAL-INFORMAL

1. CONFIDENTIAL - ENTIRE TEXT.

2. RUGGIERO HAS ASKED THAT THE FOLLOWING PAPER BE PASSED TO YOU FOR YOUR COMMENTS. IT IS THE FIRST DRAFT OF A PAPER WHICH IS TO BE PRESENTED AT THE NEXT, JANUARY, SHERPA MEETING. RUGGIERO WOULD APPRECIATE YOUR REACTIONS. COPIES ARE ALSO GOING TO THE OTHER SHERPAS FOR THE SAME PURPOSE.

3. BEGIN TEXT.

INTRODUCTION

- THE WORLD ECONOMY APPEARS TO BE MOVING TOWARDS GREATER COMPLEXITY AND CLOSER INTERACTIONS BETWEEN ITS MANY REGIONS OR GROUPS OF COUNTRIES AND BETWEEN DIFFERENT BUT CONNECTED PROBLEMS: IN PARTICULAR, THE INTERDEPENDENCIES WHICH EXIST BETWEEN GROWTH, TRADE AND INDEBTEDNESS HAVE GROWN IN IMPORTANCE AND HAVE MANIFESTED THEMSELVES WITH STARKER CLARITY IN RECENT TIMES. IT HAS BEEN INCREASINGLY RECOGNIZED BY THE SUMMIT NATIONS AND IN OTHER WORLD FORA THAT THE EXISTENCE AND EXTENT OF SUCH INTERACTIONS CALL FOR MORE EFFECTIVE PROCEDURES OF INTERNATIONAL COORDINATION WITH A VIEW TO ENSURING POLICY CONSISTENCY ACROSS COUNTRIES AND ULTIMATELY ACHIEVING GREATER CONVERGENCE OF ECONOMIC PERFORMANCE.

- IT HAS ALSO BEEN UNDERSTOOD BY ACTORS ON THE WORLD SCENE THAT NO QUICK, READY-MADE SOLUTIONS ARE AVAILABLE; ON THE CONTRARY, IN A MORE INTERDEPENDENT WORLD, IT IS PROOVING MORE COMPLEX THAN PREVIOUSLY TO DESIGN A CONFIGURATION OF POLICIES TO ENSURE MONETARY STABILITY AND CORRECT FISCAL IMBALANCES AND EXCHANGE RATE MISALIGNMENTS, WHILE AT THE SAME TIME PROMOTING NON-INFLATIONARY GROWTH, EMPLOYMENT AND TRADE.

- AFTER A PERIOD OF INTELLECTUAL SKEPTICISM ABOUT THE VERY POSSIBILITIES AND WAYS OF INTERNATIONAL MACRO-ECONOMIC MANAGEMENT, WHICH DOMINATED ECONOMIC THINKING, THEORIZING AND POLICY-MAKING OVER THE LATE SEVENTIES AND EARLY EIGHTIES, THERE IS NOW A CHANGED CLIMATE SUGGESTING A RENEWED APPRECIATION OF THE NEEDS FOR A GLOBAL COOPERATIVE EFFORT. WITHOUT IT THE SYSTEM WOULD BE LEFT UNBOUNDED, ITS SELF-CORRECTING FORCES LARGELY UNABLE TO OVERCOME RECURRENT SHOCKS.

- DEVELOPMENTS IN EXCHANGE MARKETS HAVE LATELY REFLECTED THIS NEW APPRECIATION. SIGNIFICANT ADJUSTMENTS IN CURRENCY RATES HAVE OCCURRED SINCE THE PLAZA AGREEMENT AND A RENEWED MOMENTUM TOWARDS A MORE STABLE EXCHANGE

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RATE ENVIRONMENT HAS ARISEN FROM THE EEC MEETING IN

GENEALOGIES AND THE RECENT US-JAPAN BILATERAL AGREEMENT. IT IS NOW BETTER UNDERSTOOD THAT EXCHANGE RATE INSTABILITY IS INDEED DETRIMENTAL TO SUSTAINED AND STABLE ECONOMIC GROWTH WORLDWIDE AND THAT CLOSE AND CONTINUED POLICY COORDINATION IS REQUIRED TO PREVENT THAT INSTABILITY.

1. THE WORLD ECONOMIC OUTLOOK: THE INDUSTRIAL COUNTRIES.

- SINCE THE TOKYO SUMMIT MEETING, MOST INDICATORS HAVE SIGNALLED AN IMPROVED PERFORMANCE IN THE INDUSTRIAL ECONOMIES, AS COMPARED WITH THE DISAPPOINTING DEVELOPMENTS IN EARLY 1986, WHEN THE NEGATIVE INITIAL EFFECTS FROM THE SHARP FALL IN OIL PRICES AND THE RESULTING DECLINE IN THE OIL EXPORTING COUNTRIES' PURCHASING POWER AND IMPORTS DOMINATED THEIR BENEFICIAL REPERCUSSIONS ON REAL INCOMES AND DOMESTIC DEMAND.

- THE WORLD ECONOMY IS STILL IN A PROCESS OF TRANSITION ADJUSTING TO UNUSUALLY PRONOUNCED CHANGES IN RELATIVE PRICES AND INCOMES WHICH HAVE OCCURRED SINCE THE BEGINNING OF THE YEAR: OIL AND OTHER COMMODITY PRICES HAVE DROPPED SIGNIFICANTLY, AVERAGE INFLATION RATES AND INFLATION DIFFERENTIALS AMONG COUNTRIES HAVE COME DOWN, INTEREST RATES HAVE DECLINED, THE EXCHANGE RATE OF THE DOLLAR HAS DEPRECIATED IN RELATION TO THE OTHER LEADING CURRENCIES, REVERSING NEARLY ALL OF ITS RISE FROM 1980 TO EARLY 1985. MOST RECENTLY THERE WERE, ESPECIALLY IN EUROPE, MORE COMFORTING SIGNS OF A PICKUP IN DOMESTIC DEMAND AND OUTPUT HELPED BY POSITIVE PRICE AND WAGE

DEVELOPMENTS, FALLING INTEREST RATES AND A MORE FAVORABLE CONFIGURATION OF EXCHANGE RATES. PRIVATE DOMESTIC DEMAND, PARTICULARLY CONSUMPTION, IS STRENGTHENING TO TAKE UP THE SLACK LEFT BY THE DECELERATION OF PUBLIC SPENDING (IN THE US AND CANADA) AND THE CONTRACTION OF NET EXPORTS (IN JAPAN AND MOST EUROPEAN COUNTRIES).

- ACCORDING TO THE FORECASTS RECENTLY RELEASED BY INTERNATIONAL ORGANIZATIONS, DOMESTIC DEMAND IN THE SUMMIT COUNTRIES SHOULD INCREASE BY THREE AND A HALF PER CENT IN 1986 AND PERHAPS AT A SOMEWHAT LOWER RATE IN 1987, WHILE OUTPUT SHOULD GROW AT RATES OF TWO AND A HALF TO THREE PER CENT THROUGHOUT THE PERIOD. IN THE SURPLUS COUNTRIES, JAPAN AND TO A LESSER DEGREE THE ETC STATES, DOMESTIC DEMAND IS EXPANDING AT A FASTER PACE THAN GDP AND THE FAVORABLE TREND IS EXPECTED TO CONTINUE INTO 1987. IN THE U.S. THE RISE IN DOMESTIC DEMAND IS STILL OUTPACING THAT OF OUTPUT BUT SUCH DEVELOPMENTS SHOULD BE REVERSED IN 1987, ACCORDING TO PRESENT PROJECTIONS. IN SUM, THE PROSPECTS ARE FOR CONTINUED RECOVERY INTO A FIFTH YEAR WITHOUT A RESURGENCE OF INFLATION. SOME MODERATE ACCELERATION IN PRICES IS PREDICTED, HOWEVER, FOR 1987, AS THE ONCE-OVER EXTERNAL BENEFITS FROM FALLING COMMODITY PRICES WEAR OFF AND DOMESTIC COSTS MAY PICK UP SOMEWHAT. GREAT UNCERTAINTY SURROUNDS THE BEHAVIOR OF OIL MARKETS; A FIRMING UP OF PRICES MIGHT RESULT IN A LESS FAVORABLE OUTCOME FOR INFLATION.

- STILL, IT IS CLEAR THAT PROBLEMS OF A SYSTEMIC NATURE REMAIN, ENTAILING SERIOUS RISKS TO OVERALL GROWTH AND STABILITY: THE MEANNESS OF WORLD TRADE AND THE DISSEMINATION OF RESTRICTIONS TO FREE EXCHANGES; THE SUSTAINABILITY OF CURRENT ACCOUNT IMBALANCES BETWEEN MAJOR COUNTRIES; THE VOLATILITY OF EXCHANGE RATES; THE MAGNITUDE OF PUBLIC SECTOR DEFICITS.

G.M.

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RATES WOULD ALLOW DEBT-CONSTRAINED LDCs TO SHIFT THEIR REVENUES FROM DEBT-SERVICE PAYMENTS TO IMPORTS. FOR PRIMARY PRODUCING COUNTRIES, IN PARTICULAR, STABLE OR RISING AND ADEQUATELY REMUNERATIVE COMMODITY PRICES WOULD HELP REDRESS THEIR PRECARIOUS EXTERNAL POSITION, THE MORE SO IF THEY WERE COUPLED WITH THE REMOVAL OF TRADE RESTRICTIONS EXISTING IN THOSE MARKETS.

- CORRECTIVE MACROECONOMIC POLICIES AND STRUCTURAL REFORMS IN DEBTOR COUNTRIES WOULD BE SUPPORTED BY ADEQUATE FLOWS OF EXTERNAL FINANCE FROM ALL CREDITORS--MULTILATERAL DEVELOPMENT INSTITUTIONS, GOVERNMENTS AND PRIVATE LENDERS--IN LINE WITH THE REQUIREMENTS OF THE DEBT-RELIEF STRATEGY LAUNCHED BY THE U.S. IN OCTOBER 1985 AND ENDORSED BY THE TOKYO SUMMIT. IN PARTICULAR, COMMERCIAL BANKS WOULD NEED TO RESUME NORMAL LENDING IN SUFFICIENT AMOUNTS AND ON APPROPRIATE TERMS

- A FURTHER IMPETUS TO WORLDWIDE GROWTH WOULD ARISE FROM TRADE LIBERALIZATION; AS IT WAS INDEED REAFFIRMED BY THE SUMMIT COUNTRIES IN THE TOKYO MEETING, MAINTAINING AN OPEN MULTILATERAL TRADING SYSTEM IS A CONDITION AND KEYSTONE OF AN EFFICIENT AND EXPANDING WORLD ECONOMY. SINCE THEN AND CULMINATING IN THE DECISIONS ADOPTED AT THE GATT MINISTERIAL MEETING IN URUGUAY LAST SEPTEMBER, PROGRESS HAS BEEN MADE IN OUTLINING A GENERAL FRAMEWORK FOR ACTION TO PROMOTE A NEW ROUND OF TRADE NEGOTIATIONS. THERE IS MUCH INERTIA AND RESISTANCE TO CHANGE ON THIS FRONT; BUT COMPLIANCE WITH THE PRINCIPLE OF "STANDSTILL" IN TRADE RESTRICTIONS WOULD HAVE A BENEFICIAL IMPACT PER SE. GOODWILL, AS IT WAS SIGNALED BY ALL CONCERNED PARTIES, AND A RESUMPTION OF STRONGER GROWTH IN THE WORLD ECONOMY WOULD HELP SPEED UP THE PROCESS.

- EXTERNAL IMBALANCES AMONG THE INDUSTRIAL COUNTRIES WOULD BE CORRECTED ONLY AS LARGE SHIFTS OCCURRED IN THE PATTERN OF DEMAND AMONG THE LEADING PARTNERS: INDEED, AS DOMESTIC DEMAND GREW FASTER THAN GDP IN JAPAN AND GERMANY, AND THE REVERSE HAPPENED IN THE U.S. RECENT EXCHANGE-RATE ADJUSTMENTS WILL SUPPORT DIFFERENTIAL GROWTH IN DEMAND, HELPING APPRECIATING-CURRENCY COUNTRIES TO REORIENT ACTIVITY TOWARDS DOMESTIC DEMAND AND DEPRECIATING-CURRENCY COUNTRIES AWAY FROM IT. BUT IT MAY TAKE A LONG TIME FOR SUCH DIFFERENTIALS TO EMERGE WITHOUT CAUSING A SLOWDOWN IN GROWTH FOR THE WORLD ECONOMY AS A WHOLE GIVEN THE FRICTIONS AND RIGIDITIES INHERENT IN SUCH DEMAND SHIFTS.

- FURTHER AND SPEEDIER CHANGES IN CURRENCY RATES COULD BE RELIED ON TO PRODUCE A QUICKER ADJUSTMENT IN THE PRESENT IMBALANCES BUT SUCH CHANGES, E.G. A LARGER DEPRECIATION OF THE DOLLAR, COULD HAVE UNDESIRABLE DOMESTIC EFFECTS FOR BOTH THE U.S. (HIGHER INFLATION) AND THE APPRECIATING-CURRENCY COUNTRIES (SLOWDOWN IN EXPORTS AND ACTIVITY). ON THE CONTRARY, A PAUSE IN EXCHANGE RATE MOVEMENTS MIGHT BE WARRANTED IN VIEW OF THE PRESENT STATE OF TRANSITION OF THE WORLD ECONOMY AND THE NEED TO ADJUST TO THE SHARP SHIFTS WHICH HAVE OCCURRED IN EXCHANGE RATES AND RELATIVE PRICES.

- AS FAR AS THE U.S. TRADE PERFORMANCE, IN PARTICULAR, IS CONCERNED, IT APPEARS THAT THE APPRECIATION OF THE DOLLAR IN RECENT YEARS AND THE RESULTANT LOSS IN COMPETITIVENESS HAVE SERIOUSLY AFFECTED THE REAL STRUCTURE OF THE ECONOMY: THE DICHOTOMY BETWEEN THE SERVICES SECTOR--WHICH IS EXPANDING RAPIDLY--AND AGRICULTURE AND IMPORTANT MANUFACTURING INDUSTRIES WHICH ARE EXPOSED TO INTERNATIONAL TRADE HAS BEEN WORSENING AND REVERSING IT WILL PROVE A SLOW AND DIFFICULT ENDEAVOR.

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- UNDER THIS POSITIVE SCENARIO, POLICY-MAKING COULD GIVE GREATER EMPHASIS TO MEDIUM-TERM, STRUCTURAL PROBLEMS SUCH AS INCREASING THE ROLE OF MARKET FORCES IN THE ECONOMY, REFORMING TAX SYSTEMS AND BUILDING A MORE STABLE INTERNATIONAL MONETARY ORDER.

- A MORE NEGATIVE SCENARIO CAN BE OTHERWISE ENVISIONED WHICH IF IT MATERIALIZED WOULD REQUIRE CORRECTIVE ACTION

AT AN EARLY STAGE. ONE CAN CONCEIVE OF TWO VARIANTS OF SUCH A SCENARIO, THEIR COMMON DENOMINATOR BEING A WORLD RECESSION AND CONTINUED EXTERNAL IMBALANCES.

- UNDER THE FIRST ALTERNATIVE, WHILE THE U.S. BUDGET DEFICIT IS REDUCED, PRIVATE DOMESTIC DEMAND IN THE OTHER COUNTRIES TURNS OUT WEAKER THAN ANTICIPATED UNDER THE POSITIVE SCENARIO, AND THERE IS CONTINUED EMPHASIS IN POLICY SETTINGS ON FISCAL RESTRAINT. A MAJOR SOURCE OF UNCERTAINTY IN PRESENT CIRCUMSTANCES IS INDEED THE PRECISE MAGNITUDE AND TIMING OF THE EVENTUAL INCREASE OF DEMAND AND ACTIVITY IN INDUSTRIAL COUNTRIES IN RESPONSE TO THE REAL INCOME GAINS AND THE FALL IN INTEREST RATES. THE DOWNSIDE RISKS WOULD BE OBVIOUSLY GREATER SHOULD FISCAL POLICIES TURN GLOBALLY CONTRACTIONARY. SUCH AN OUTCOME COULD BE TRIGGERED, FOR INSTANCE, BY A STRONGER-THAN-PREDICTED REBOUND IN INFLATION WHICH WOULD UNDERMINE CONSUMER CONFIDENCE AND WOPSEN BUSINESS INVESTMENT PROSPECTS. FALTERING GROWTH WOULD BE REFLECTED IN LARGER BUDGET DEFICITS IN A NUMBER OF COUNTRIES, WHICH COULD SET IN MOTION A SERIES OF UNCOORDINATED MEASURES OF FISCAL RESTRICTION, INCLUDING POSSIBLY TAX RISES. THE COMBINED EFFECTS ON GROWTH OF FISCAL CONSOLIDATION IN INDUSTRIAL COUNTRIES AND OF THE REDUCTION IN NET EXPORTS TO THE DEVELOPING WORLD WOULD BE TOO LARGE TO BE OFFSET BY DOMESTIC SPENDING. STAGNATION IN THE INDUSTRIAL COUNTRIES AND IN WORLD TRADE WOULD THEN BE A LIKELY OUTCOME. THE DEVELOPING NATIONS WOULD BE FORCED TO CURTAIL IMPORTS AND PUSH DOMESTIC GROWTH DOWN TO A BREAKING POINT; COMMODITY PRICES WOULD BE FURTHER WEAKENED FEEDING BACK INTO STILL LOWER IMPORTS BY THE LDCs AND AMPLIFYING THE SLOWDOWN IN WORLD TRADE. IN SUCH A CONTEXT, THE RISKS TO THE INTERNATIONAL TRADING SYSTEM WOULD BECOME GREATER AS IT WOULD BE INCREASINGLY DIFFICULT FOR THE LEADING ECONOMIES TO RESIST PROTECTIONIST PRESSURES IN THE PRESENCE OF SHRINKING EXPORT MARKETS.

- THE SITUATION COULD BE AGGRAVATED BY DEBT-SERVICING DIFFICULTIES OR EVEN INSOLVENCY IN SOME HARD-PRESSED DEBTOR NATION: UNCERTAINTY ABOUT SUCH AN OUTCOME COULD REVERBERATE INTO FINANCIAL MARKETS IN THE INDUSTRIAL COUNTRIES RESULTING IN HIGHER INTEREST RATES.

- UNDER THE SECOND ALTERNATIVE, A RECESSION WOULD COME ABOUT AS THE LIKELY OUTCOME OF A DIFFERENT CAUSAL CHAIN AND IT WOULD BE ACCOMPANIED BY HIGHER INFLATION. THE PROCESS WOULD BE TRIGGERED BY THE FAILURE OF U.S. AUTHORITIES TO IMPLEMENT THE ANNOUNCED POLICY OF BUDGETARY RESTRAINT. IN SUCH A SCENARIO, FINANCIAL MARKETS WOULD QUICKLY REACT TO THE UNCERTAIN PROSPECTS AS MARKET PARTICIPANTS CAME TO BELIEVE THAT FISCAL IMBALANCES WOULD NOT BE BROUGHT UNDER CONTROL AND EXTERNAL DIS-EQUILIBRIA WOULD PERSIST, POSSIBLY WIDENING TO UNSUSTAINABLE LEVELS. THE MOST LIKELY CONSEQUENCE OF SUCH STRAIN WOULD BE UPWARD PRESSURE ON U.S. INTEREST RATES; DOMESTIC SPENDING AND ACTIVITY WOULD BE HURT FIRST, THEN THE CONTRACTION WOULD BE PROPAGATED TO THE PARTNER COUNTRIES. THE RISE IN INTEREST RATES MIGHT NOT BE SUFFICIENT TO PREVENT A RAPID FALL IN THE DOLLAR EXCHANGE RATE WHICH WOULD HAVE UNDESIRABLE DOMESTIC

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REPERCUSSIONS. INFLATIONARY EXPECTATIONS WOULD INDEED
BE REKINDLED AND ACTUAL INFLATION WOULD LIKELY ACCELERATE
IN THE U.S. THIS SEQUENCE OF EVENTS WOULD PLACE FURTHER
STRAIN ON INDERTED LDCS; THEIR DEBT-SERVICING DIFFICUL-
TIES WOULD BE GREATLY AGGRAVATED AS BOTH THE BURDEN OF
INTEREST PAYMENTS INCREASED AND EXPORTS SLOWED DOWN
REFLECTING WEAKER WORLD TRADE. END TEXT

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EXDIS/SHERPA - FOR DEM HOLMES

E.O. 12356: DECL: OADR

TAGS: NSUM, IT

SUBJECT: JANUARY SHERPA MEETING

1. CONFIDENTIAL - ENTIRE TEXT.
2. PLEASE PASS FOLLOWING COMMENTS FROM ALLEN WALLIS TO RENATO BUGGIERO ON HIS DRAFT SHERPA PAPER.
3. THANK YOU FOR THE INTERESTING DRAFT PAPER ON THE WORLD ECONOMY DESIGNED FOR PRESENTATION TO THE JANUARY SHERPA MEETING. IT SHOULD USEFULLY STIMULATE DISCUSSION, BUT I BELIEVE IT COULD BE IMPROVED AND SHORTENED. THE FOLLOWING COMMENTS ARE INTENDED TO BE HELPFUL IN THAT CONNECTION. THE PAPER INCLUDES A NUMBER OF ADDITIONAL JUDGMENTS THAT ARE DEBATABLE, BUT I ASSUME YOU DO NOT INTEND THE PAPER TO REPRESENT A FULL CONSENSUS, AT LEAST AT THIS STAGE.

INTRODUCTION: I SUGGEST THAT YOU GREATLY SIMPLIFY THE INTRODUCTORY SECTION, STICKING TO A BROAD CHARACTERIZATION OF THE PRESENT SITUATION. IT WOULD BE BEST TO ELIMINATE DUBIOUS INTERPRETATIONS OF INTELLECTUAL TRENDS AND AVOID SUCH UNFOUNDED OBITER DICTA AS "WITHOUT IT (A

GLOBAL COOPERATIVE EFFORT), THE SYSTEM WOULD BE LEFT UNBOUNDED, ITS SELF-CORRECTING FORCES LARGELY UNABLE TO OVERCOME RECURRENT SHOCKS." THERE IS LITTLE SIMILARITY BETWEEN GLENAGIES, BASICALLY JUST A FIXED RATE IDEA, AND THE U.S.-JAPAN BILATERAL AGREEMENT, WHICH EMPHASIZED FUNDAMENTAL POLICIES TO PROMOTE GROWTH AND ADJUSTMENT WHILE EXPRESSING THE VIEW THAT EXCHANGE MARKETS HAVE NOW GOT THE YEN-DOLLAR RATE ABOUT RIGHT.

OUTLOOK FOR INDUSTRIAL COUNTRIES: ASSESSMENT IN THIS SECTION SEEMS ABOUT RIGHT. HOWEVER, SOME OF THE PROBLEMS CITED IN THE FOURTH PARAGRAPH OF THIS SECTION ARE NOT REALLY "SYSTEMIC", BUT RATHER COUNTRY-SPECIFIC CONTRIBUTING FACTORS (U.S. BUDGET DEFICIT) OR SYMPTOMS (HIGH EUROPEAN UNEMPLOYMENT). IT SHOULD BE NOTED THAT THE U.S. DEFICIT IS TRENDING DOWNWARD AND THAT INTEREST RATES OVERALL ARE DOWN SUBSTANTIALLY, EVEN THOUGH THEY MAY STILL BE HIGH IN SOME COUNTRIES.

DEVELOPING COUNTRIES AND DEBT: COMBINING DATA ON OIL-EXPORTING AND NON-OIL DEVELOPING COUNTRIES IS MISLEADING, GIVING AN UNDULY GLOOMY PICTURE. IN FACT, NON-OIL DEVELOPING COUNTRIES ARE NOT DOING BADLY. FOR EXAMPLE:

-- NON-OIL DEVELOPING COUNTRIES ARE ACHIEVING PROGRESS ON REDUCING EXTERNAL IMBALANCES IN A CONTEXT OF GROWING, NOT DECLINING, IMPORTS. STRUCTURAL REFORMS ARE BEING UNDERTAKEN IN A NUMBER OF COUNTRIES THAT WILL STRENGTHEN CREDITWORTHINESS AND THE CAPITAL-TRANSFER PROCESS IN THE LONG TERM;

-- SUBSTANTIAL DECLINES IN INTEREST RATES (LIBOR DOWN NEARLY 5 PERCENTAGE POINTS SINCE 1984) WILL SAVE MAJOR DEBTORS OVER DOLS. 13 BILLION IN ANNUAL INTEREST COSTS;

-- FOR MAJOR DEBTORS, A SIGNIFICANT IMPROVEMENT IS IN PROSPECT ON THE RATIO OF INTEREST PAYMENTS TO EXPORTS -- ABOUT 25 PERCENT IN 1987 COMPARED TO 31 PERCENT IN 1982. (COMPARE THIS WITH THE DOWNBEAT TREATMENT IN THE PENULTIMATE PARAGRAPH OF THIS SECTION.)

IN THE FOURTH PARAGRAPH OF THIS SECTION YOU COULD USEFULLY NOTE THAT THREATS TO "THE SOUNDNESS AND ORDERLY FUNCTIONING OF THE WORLD FINANCIAL SYSTEM" ARE NOW SUBSTANTIALLY REDUCED AS A RESULT OF MEASURES TAKEN BY THE CREDITOR BANKS TO STRENGTHEN THEIR CAPITAL POSITIONS.

THE GLOOM IN THE FINAL PARAGRAPH OF THE DEVELOPING

-COUNTRY SECTION RESTS HEAVILY ON THE FALLACIOUS "NET TRANSFER" CONCEPT WHICH, TO QUOTE THE OECD'S 1985 SURVEY, "FINANCING AND EXTERNAL DEBT", "CONTRAVENES BASIC ECONOMIC LOGIC BY ANALAGATING CAPITAL TRANSACTIONS AND INCOME (INTEREST) TRANSACTIONS" AND "IS TOO EASILY MISLEADING, ALL THE MORE SO WHEN IT AGGREGATES DIFFERENT TYPES OF DEBTOR COUNTRIES TOGETHER" (P. 89, 90). AS STATED IN THE OECD'S 1983 SURVEY, "THE POLICY CHALLENGE IS NOT TO GET BACK TO ANY PARTICULAR LEVEL OF 'NET FINANCIAL TRANSFER', BUT RATHER TO ENSURE, IN A BROAD SENSE, THAT THE CAPITAL TRANSFER PROCESS IS WORKING EFFECTIVELY" (P. 20).

SCENARIOS: THE PRESENTATION IS TOO EVEN-HANDED IN THE EMPHASIS GIVEN TO THE ALTERNATIVE SCENARIOS AND LACKS POLICY FOCUS. NEGATIVE SCENARIO NUMBER ONE MIGHT BE MERGED WITH THE POSITIVE SCENARIO, AS A WAY OF HIGHLIGHTING UNCERTAINTIES AND WEAKNESSES IN A BASICALLY FAVORABLE OUTLOOK. IT COULD BE ARGUED THAT THE RISK IS NOT SO MUCH THAT THE EUROPEAN AND JAPANESE ECONOMIES MAY GROW MORE SLOWLY THAN CURRENTLY FORESEEN, BUT THAT THEIR DOMESTIC-LED GROWTH MAY NOT BE SIGNIFICANTLY STRONGER THAN NOW SEEMS EVIDENT. WITHOUT FURTHER DOLLAR DEPRECIATION OR U.S. RECESSION THIS MIGHT LEAVE THE U.S. WITH A STILL-SUBSTANTIAL CURRENT ACCOUNT DEFICIT FOR THE FORESEEABLE FUTURE.

FURTHER SPECIFIC COMMENTS ON THIS SECTION:

-- THE APPARENT SUPPORT OF HIGHER OIL PRICES IN PARAGRAPH THREE IS UNACCEPTABLE. ALSO, THE REFERENCE TO "STABLE OR RISING AND ADEQUATELY REMUNERATIVE COMMODITY PRICES" COULD BE INTERPRETED TO IMPLY BELIEF THAT COMMODITY PRICES ARE DUE FOR SOME UPWARDS CORRECTION, AND THAT THERE EXISTS SOME HIGHER NORMATIVE LEVEL FOR COMMODITY PRICES. NEITHER PROPOSITION IS SOUND.

NEITHER CAN WE ACCEPT THE IDEA OF ATTEMPTING TO PRODUCE A PAUSE IN EXCHANGE-RATE MOVEMENTS (PARAGRAPH SEVEN). THE

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MARKET HAS SO FAR PRODUCED AN ORDERLY AND BENEFICIAL ADJUSTMENT IN RATES; WHY ASSUME THAT IT IS NOT CAPABLE OF PERFORMING WELL IN THE FUTURE? WHETHER FURTHER DOLLAR DEPRECIATION IS WARRANTED REMAINS TO BE SEEN, DEPENDING LARGELY ON POLICIES TO BE ADOPTED IN THE U.S. AND IN MAIN TRADING PARTNERS.

-- IN PARAGRAPH EIGHT, THE REFERENCE TO A "WORSENING DICHOTOMY" APPEARS INFELICITOUS. I ASSUME THAT YOU INTENDED TO SUGGEST THAT THE INTERNATIONAL COMPETITIVE-

NESS OF U.S. MANUFACTURING AND AGRICULTURE HAS BEEN DAMAGED IN SOME LASTING WAY BY THE EXPERIENCE WITH THE STRONG DOLLAR. THIS VIEW CANNOT BE SUSTAINED AS A GENERAL PROPOSITION. CERTAIN INDUSTRIES THAT WERE LOSING INTERNATIONAL COMPETITIVENESS FOR MORE FUNDAMENTAL REASONS MAY HAVE HAD THEIR DECLINE ACCELERATED; THEY MAY NOT RECOVER. OTHERS, HOWEVER, MAY ACTUALLY HAVE BECOME MORE EFFICIENT IN RESPONSE TO COMPETITIVE PRESSURE, AND SHOULD COME BACK STRONGLY WITH THE DOLLAR'S ADJUSTMENT. U.S. FARMERS HAVE BEEN HURT BY RECENT DEVELOPMENTS, BUT THE SHAKE-OUT DOESN'T MAKE THE AGRICULTURAL SECTOR LESS COMPETITIVE. AS RECOGNIZED AT THE TOKYO SUMMIT, THE REAL PROBLEMS WITH AGRICULTURE STEM FROM AGRICULTURAL POLICIES.

FINALLY, I WOULD GIVE MORE EMPHASIS IN THE PAPER TO THE FACT THAT THE GREATEST THREAT TO THE HEALTH OF THE WORLD ECONOMY OVER THE NEXT FEW YEARS IS A LAPSE INTO A PROTECTIONIST SPIRAL. AVERTING THAT DANGER AND ACHIEVING NEEDED REFORM OF AGRICULTURAL POLICIES SHOULD HAVE THE HIGHEST PRIORITY.

BEST WISHES FOR THE HOLIDAY SEASON. I LOOK FORWARD TO SEEING YOU AT OUR NEXT SHERPA MEETING.

ALLEN WALLIS.
ARMACOST

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